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No. 83-1855

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

JAMES S. GARVEY, *et al.*,
Petitioners,
v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

I. The Government's Case Depends on Rewriting the Statute Which Was Written by Congress.

The only statutory provision which has a bearing on this case is section 72 of the Internal Revenue Code, set out in full at pp. 55a-57a of the Appendix to the Petition.

This statute specifically provides that—

> (b) *Exclusion Ratio.* Gross income does not include that part of any amount received as an annuity . . . which bears the same ratio to such amount

> as the *investment in the contract* . . . bears to the expected return under the contract.

(Emphasis supplied.)

The phrase "investment in the contract" is then defined in paragraph (c) of the section, as follows:

> (1) Investment in the Contract—For purposes of subsection (b), the investment in the contract . . . is—
>
> (a) *the aggregate amount of premiums or other consideration paid for the contract,* minus
>
> (b) the aggregate amount received under the contract . . . .

(Emphasis supplied.)

The question of construing the statute as Congress wrote it seems fairly simple and clear. The "investment in the contract" is "the aggregate amount of premiums or other consideration paid." The "consideration paid" in this case was clearly the fair-market value of the property transferred to the annuity-paying corporation. It was *not* the "basis" of that property. Indeed, under the terms of the statute, the "basis" of the "consideration paid" is wholly irrelevant in determining the "exclusion ratio."

As written by Congress, the "exclusion ratio" relates *solely* to the determination of the "interest" element in the annuity payment. Congress made no provision whatever in section 72 with respect to the capital gain involved in the use of appreciated property to pay for the annuity.

This does not mean that the capital gain goes free of tax. On the contrary, that gain is taxable when received —that is, after the taxpayer has recovered his basis. As shown in the petition, this was long the view of the Treasury and of the courts. Indeed, as long as thirty-five years ago, the Third Circuit held this rule was "now well established." *Commissioner v. Kann's Estate,* 174 F.2d

357, 359 (3rd Cir. 1949).[1] There has been no change in the statute since that time as far as capital gain is concerned. There has been a change in the statute with respect to the computation of the "interest element," but the statute which Congress wrote in 1954 does not in any way deal with the computation of capital gain.

Indeed, the Government's whole case turns on its espousal of the reasoning of the Claims Court, that taxation of capital gain before basis is recovered would be "more in keeping with the statutory scheme." Pet. App. 44a, repeated in Br. in Opp. 4. In other words, Congress is to be held to have said something which it did not say. This rewriting of the statute works considerable unfairness on petitioners and others similarly situated.[2] As this Court has said: "When the profit, if any, is actually realized, the taxpayer will be required to respond." *Burnet v. Logan*, 283 U.S. at 413. The Treasury's action here rewrites the law as written by Congress, and imposes a tax on a gain which may never be realized. It should not be permitted to stand.[3]

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[1] *Cf. Edgar v. Commissioner*, 56 T.C. 717, 742 n.15 (1971): "As a general rule, private annuity agreements, contingent both on the annuitant's lifespan and the obligor's ability to make the payments, do not constitute amounts realized as income within the meaning of sec. 1001(b). See, e.g., *Commissioner v. Kann's Estate*, 174 F.2d 357 (C.A. 3, 1949)."

[2] The authors of a recent comprehensive study of the taxation of private annuities have written:

> The inequity of taxing a "gain" that may never materialize (as where the annuitant dies before recovering the basis of his property exchanged for the annuity) is perhaps the most compelling argument in favor of open transaction treatment.

Warnick, "Private Annuities," 195-3rd Tax Management (BNA), Estates, Gifts & Trusts A-13 (1984).

[3] There is a further incongruity in the Government's position, though it is not directly involved in this case. Under Rev. Rul. 74, 1969-1 C.B. 43, the capital gain involved is taxed ratably over the annuitant's life expectancy, even during the period when he cannot

II. Respondent Seeks to Minimize the Conflict Below by Citing Cases Unrelated to the Question Involved Here.

The decision below departs diametrically from other decisions which hold that the realization of capital gain on the purchase of a private annuity is governed by this Court's holding in *Burnet v. Logan*. Pet. 5-11. The weakness of the Government's position is emphasized by its careless use of authorities. It relies (Br. in Opp. 7) on four cases, none of which applies remotely to the income taxation of private annuities.

Three of the cases which respondent cites do not even mention annuities. *Campbell v. United States*, 228 Ct. Cls. 661, 661 F.2d 209 (1981), involved the valuation of restricted securities received on the sale of a family-held corporation. *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), involved the sale of real property under a deferred-payment contract. *Clodfelter v. Commissioner*, 426 F.2d 1391 (9th Cir. 1970), concerned the receipt of contingent installment payments on the sale of a business. None of these cases would suggest to a reasonable taxpayer that *Evans v. Rothensies*, 114 F.2d 958 (2d Cir. 1940), *Commissioner v. Kann's Estate*, 174 F.2d 357 (3rd Cir. 1949), and the numerous other cases cited in the petition no longer represent the proper application of *Burnet v. Logan* to private annuities.

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be sure that he will recover his basis. If he lives beyond his life expectancy (as half, more or less, of all annuitants will), then the Treasury says that the exclusion ratio no longer applies, and that everything received is taxable as *ordinary* income. There is nothing in the statute which supports this conclusion.

The result is that the Government wins both ways. It gets an unwarranted capital gain tax from the person who does not live long enough to recover his basis. On the other hand, if an annuitant outlives his expectancy, then the continuing gain from the transfer of the consideration for the annuity is taxable as ordinary income, even though the gain, whatever amount it turns out to be, is clearly derived from the transfer of a capital asset.

The fourth case cited by respondent actually *confirms* the application of *Burnet v. Logan* to private annuities. In *Bruce v. United States*, 254 F. Supp. 816 (S.D. Tex. 1966), *aff'd per curiam*, 370 F.2d 569 (5th Cir. 1967), *cert. denied*, 386 U.S. 1030, a taxpayer sought to defer realization of income derived from shares in a petroleum royalty trust until payments from the trust exceeded the taxpayer's basis in his shares. The court denied application of *Burnet v. Logan*, noting that the taxpayer could, at all relevant times, have sold his shares in the over-the-counter market for a price greatly in excess of his basis. The court, however, *distinguished* the royalty from an annuity. It said:

> [T]he distinguishing point about an annuity contract is that one never knows if the holder will live long enough to recoup his capital investment. The prospect of receiving income or interest is most uncertain.

254 F. Supp. at 819.[4] It is difficult to see what comfort respondent derives from *Bruce*. The case simply underscores the departure of the decision below from other decisions governing private annuities.

III. Respondent Seeks to Divert Attention from the Legislative History, Which Makes Plain That Respondent's Position Defies the Intent of Congress.

Twice—first in 1954 and later in 1963—Congress considered, and decided against, overruling *Burnet v. Logan* as it applies to the capital gain element in private annuities. Pet. 13-16. In each instance, legislative history indicates quite plainly that both Congress and the Treasury Department understood that *Burnet v. Logan* remained

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[4] The court noted parenthetically that the Code now requires taxation of certain payments on annuities before basis is recovered. *Id.* This refers however, to the *interest* element of the annuity, which is taxed under § 72 of the Code, not the capital-gain element which is involved in the present case.

the law applicable to the capital gain element in private annuities. Pet. 14-16. One of these occasions was contemporaneous with the enactment of section 72, and the other was nine years after that enactment. Both expressly recognized the continuing applicability of *Burnet v. Logan* to private annuities.

Respondent now seeks to divert attention from these legislative materials, not by pointing to legislative history to the contrary (of which none is known), but by arguing that the changes which Congress considered in 1954 and 1963 differed from the change which respondent now seeks to impose. The 1954 and 1963 proposals would have required taxation of the total potential gain immediately on the transfer of property for a private annuity, whereas respondent now seeks to require realization of this gain ratably beginning with the first annuity payment. But this distinction is irrelevant to the present question. Respondent's method, like the method which Congress rejected in 1954 and 1963, would require realization and taxation of gain *before the taxpayer's basis has been recovered.* That is why respondent's current position violates *Burnet v. Logan* and its progeny, and that is why Congress in 1954, and Congress and the Treasury in 1963, recognized that the changes then under consideration represented departures from *Burnet v. Logan.* Respondent should not now be permitted to overturn *Burnet v. Logan* where Congress has twice refused to do so.

IV. Respondent Misapplies This Court's Holding in *United States v. Davis.*

Respondent incorrectly seeks support from *United States v. Davis,* 370 U.S. 65 (1962).[5] As pointed out in the petition, *Davis* and *Burnet v. Logan* involve two entirely distinct questions. *Davis* involves the question of

[5] The Claims Court (Pet. 40a-41a), but not the court of appeals, makes similarly mistaken use of *Davis.*

how property should be valued after it has been *received* in full. *Logan* involves the question of *when* gain should be recognized, where consideration stated in a contract *may never be received at all.*

CONCLUSION

The opinion of the court below represents an unwarranted departure from the statute, and from plainly stated holdings of other federal courts which apply *Burnet v. Logan* to the taxation of private annuities. The question is a recurring one which ought to be settled, like those in *United States v. Cartwright*, 411 U.S. 546 (1973), or *Dickman v. Commissioner*, 104 Sup. Ct. 1086 (1984).

The petition for certiorari should be granted, and the decision below should be reversed.

Respectfully submitted,

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August, 1984